



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

MAR 29 2002

Honorable Roderick Paige
Secretary of Education
Washington, D.C. 20202

Dear Mr. Secretary:

Attached are copies of the final management letters prepared by Ernst & Young, LLP, as a result of their examination of the fiscal years 2001 and 2000 financial statements for the Department and Student Financial Assistance. Copies are also being provided to the Office of the Chief Financial Officer, the Office of the Chief Information Officer, the Office of the Under Secretary, and Federal Student Aid.

The letters contain suggestions to assist management in improving procedures and controls within the Department. The results were discussed with Department officials throughout the audits. The Office of the Chief Financial Officer and Federal Student Aid commented on the findings and recommendations presented in the draft management letters and changes were incorporated as appropriate.

In accordance with the Freedom of Information Act (Public Law 90-23), products issued by the Office of Inspector General are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us and Ernst & Young, LLP, during the audits.

Sincerely,

A handwritten signature in cursive script, reading "Lorraine Lewis", is written over the typed name.

Lorraine Lewis

Enclosures

U.S. DEPARTMENT OF EDUCATION

Comments on Internal Control and Other Matters

Year ended September 30, 2001

 **ERNST & YOUNG**

To the Inspector General
U.S. Department of Education

In planning and performing our audits of the consolidated balance sheets of the U.S. Department of Education (the Department) in accordance with auditing standards generally accepted in the United States as of September 30, 2001 and 2000, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing for the fiscal years then ended, we considered its internal control to determine our audit procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on internal control. We have separately reported in our Report on Internal Control dated February 4, 2002, certain matters involving internal control and its operation that we consider to be reportable conditions or material weaknesses under standards established by the American Institute of Certified Public Accountants.

The following suggestions, which resulted from our consideration of internal control, are submitted to assist management in improving procedures and controls.

I. Fund Balance with Treasury

Statement of Transactions Preparation Process (Repeat Condition)

The Department's procedures for reporting its Fund Balance with Treasury (FBWT) activities to Treasury can be improved. During our testing of the Department's procedures for preparing the Statement of Transactions (SF 224), we noted that the collection and disbursement transactions reported to Treasury via the SF 224 differed from transactions posted to the Department's general ledger, the Financial Management System Software (FMSS). The Department prepared the SF 224 by using the data provided in the Government On-Line Accounting Link System (GOALS) and Cash Link, instead of the data in its general ledger. Consequently, the collections activity recorded in the general ledger for the Direct Loan financing account, and the collections and disbursements activity recorded in subsidiary ledgers for the FFELP financing and liquidating accounts do not agree with the amounts reported in the Undisbursed Appropriation Ledger (FMS 6653). The activity in the general ledger and subsidiary ledgers exceeded the amounts reported in the FMS 6653 by \$2.7 billion and \$738 million for the direct loan financing account, and FFELP financing and liquidating accounts, respectively. While we were able to satisfy ourselves as to the Fund Balance with Treasury balance at year-end, the differences reflected the Department's effort through manual adjusting entries to correct past errors and inadequacies in its Fund Balance with Treasury reconciliations. Also, the amounts reported on the Statement of Differences (FMS 6652) do not reflect true differences between balances in the Department's general ledger and balances reported by Treasury in the FMS 6653.

A GAO report, *Reconciliation of Fund Balances* (GAO/AIMD-97-104R), established guidance for use by auditors in determining the adequacy of an agency's procedures to reconcile its FBWT. This guidance suggests that auditors determine whether agencies adequately prepare the

SF 224 by using the same detailed accounting records of collection and disbursement transactions that are used to prepare the agencies' financial statements. The guidance also suggests that auditors determine whether agencies adequately research and resolve differences reported by Treasury on the Statement of Differences (SF 6652) and report adjustments to Treasury and post adjustments to accounting records in a timely manner (i.e. monthly).

We recommend that the Department perform the following:

- Modify the procedures used to record transactions in its accounting records for all Agency Location Codes (ALC's) so that the SF 224 preparers can effectively rely on the accounting data from the general ledger and accurately report transactions to Treasury.
- Perform reconciliations of its FBWT on a monthly basis for all major appropriations and quarterly for other appropriations.
- Thoroughly research differences and clearly document the resolution of the differences, including prior year differences.
- Post all correcting general ledger entries identified through the reconciliation process and communicate those entries promptly to Treasury via the SF 224.

Department Response:

This was addressed in the Internal Control Report

II. Direct Loans

GAPS to FMSS Loan Disbursement Reconciliations

The Grant Administration and Payment System (GAPS) processes requests for disbursing loan funds to schools. We tested a sample of the GAPS subsidiary to FMSS general ledger reconciliations for loan disbursements and noted that these reconciliations lacked documentation of supervisory review and approval. The lack of supervisory review and approval increases the risk that the reconciliations may contain errors or irregularities that may not be detected timely.

OMB Circular A-123, *Management Accountability and Control*, states that, "Transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports. The documentation for transactions, management controls, and other significant events must be clear and readily available for examination."

We recommend that the Department ensure that supervisory review and approval of all reconciliations is documented.

Department Response:

The Department agrees that the reconciliation approval documentation can be improved.

Action to Be Taken:

- Department management will maintain formal approval documentation.

III. FFELP Loans Receivable

Lack of Borrowers' Information

Lack of complete and accurate borrowers' information may impair the Department's ability to improve collections and effectively service defaulted loans assigned to the Department. Of the 32 confirmations sent to borrowers to confirm loan balances at year-end, five confirmations were returned as undeliverable. In addition, the Department was able to provide telephone numbers for only 19 borrowers. Four of the telephone numbers provided were either not in service or wrong numbers.

While we recognize that defaulted loans present unique challenges, we recommend that the Department continue to review its collection and file maintenance practices and determine if additional measures would aid in updating borrowers' records in the Debt Collection Service.

Department Response:

The Department exhausts every possible resource in its collection practices and file maintenance. The Department/Collections receives address and telephone information from the entity (school, FFEL Guarantor, Direct Loan Servicer, etc.) assigning the student loan/grant to the Department. If this contact information is not provided or determined to be incorrect, there are several tools utilized to ascertain current data:

- Skip-trace account through a service provided by the Internal Revenue Service. DCS files are timely update from the skip-tracing results.
- Skip-trace activities are also routinely performed once an account is referred to Private Collection Agency (PCA) contractors. PCAs utilize various options available to them (i.e., Credit Bureaus, private locator contracts, etc.). The PCAs provide this data to Collections weekly, so that the Debt Management Collection System is updated in a timely manner.
- Match accounts against the National Directory of New Hires. This Directory provides home and employment contact information. DCS files are timely updated from the matching results.
- Request address update information from the U.S. Postal Service. DCS files are again timely updated.

In short, the Department/Collections spends considerable time, effort and resources to locate borrowers. Our collection efforts have long been used as the standard in Federal collection efforts.

IV. Accounts Receivable

The Department's procedures for reviewing and calculating the allowance for loss on accounts receivable can be improved. During our testing, we noted the following issues:

- The Department did not follow their current policies and procedures for calculating the allowance for loss on certain accounts receivable transactions, resulting in the allowance account being understated; however, the amounts involved were not material to the financial statements as a whole.
- We also noted that certain items included in the Department's subsidiary listing that were considered to be current had 100% allowance applied against them as part of the Department's allowance procedures. This could potentially overstate the allowance account.
- The allowance for loss was not applied to the correct general ledger sub-account or sector code in some cases. This resulted in 2 accounts receivable sub-accounts having a net credit balance at year-end (the amount of the allowance exceeded the amount of the receivable). In addition, certain immaterial amounts were misclassified between intragovernmental and governmental accounts receivable on the balance sheet. These items did not impact the overall net accounts receivable balance.
- The Department did not perform a timely review of the allowance for loss and accounts receivable general ledger accounts.

The Office of the Chief Financial Officer's procedures entitled *Assessing and Adjusting for Loss on Accounts Receivable* establishes the methodology for calculating the allowance for all grant programs. This document calls for adjusting the allowance on accounts receivable to 97% of all unappropriated funds and 100% of all appropriated funds. These procedures should be performed on a quarterly basis and at year-end.

Without timely and adequate review of accounts receivable and allowance for loss general ledger accounts, the accounts receivable balances are more likely to become misstated. While the differences noted during FY 2001 were not material to the financial statements as a whole, timely account analysis and review procedures could have identified these discrepancies.

We recommend that the Department perform the following:

- Comply timely with existing policies and procedures to perform quarterly assessment and adjustment of allowance for loss on accounts receivable.
- Perform analysis and review of accounts receivable and allowance for loss accounts to determine that amounts have been posted to the correct sub-account and sector code.
- Determine whether existing allowance percentages are appropriate, or whether alternate methods, such as establishing allowance percentages based on an aging schedule reflecting the status of the receivables, would provide a more appropriate methodology for calculating the allowance for loss.

Department Response:

The Department concurs with the overall intent of the recommendation.

Action to Be Taken:

- Department management will review this issue and institute measures, as appropriate, to ensure that staff are in compliance with the existing A/R allowance calculation policies and procedures.
- The current allowance assessment method will be evaluated. The evaluation project will also include a phase in which the Department will review alternative methods of assessment. Recommendations will be made upon conclusion.

V. Monitoring***Monitoring of Guaranty Agency Reserve Funds (Modified Repeat Condition)***

After analyzing the information reported on Form 2000, "Guaranty Agency Quarterly/Annual Report", we noted that guaranty agencies are only required to report balances for the Federal Fund and the Restricted Recall Fund balance as of September 30 each year. As a result, guaranty agency reserve balances can only be verified at year-end. Guaranty agencies are required to submit other information, such as loans receivable, on a quarterly basis.

One of the uses of the Form 2000 is to track the financial condition of the guaranty agencies. This function will not be as effective if the reserve balances are only reported at year-end.

We recommend that the Department revise the Form 2000 to include the requirement that each guaranty agency report the Operating, Federal, and Restricted Recall Fund balance on a quarterly basis, which will allow the tracking of reserve balances throughout the fiscal year instead of only at year-end.

Department Response:

The Department agrees with the intent of the recommendation.

Student Financial Assistance (SFA) does not want to require the GA's to submit the entire annual report (all line items) on a quarterly basis. Rather, agencies would continue to submit the Annual Report (all line items) on an annual basis.

The Form 2000 should be revised to include the requirement that each GA report only the balances of the Operating, Federal and Restricted Fund on a quarterly basis.

Action to Be Taken:

- SFA plans to revise the Form 2000, "Guaranty Agency Quarterly/Annual Report" to include the requirement that each GA report only the balances of the Operating,

Federal, and Restricted Recall Fund on a quarterly basis. This will allow SFA to track the reserve balance throughout the fiscal year instead of only at year-end.

Monitoring for Vocational Education Grants

The Department's monitoring of vocational education grants can be improved. In FY 2001, the Office of Vocational and Adult Education (OVAE) performed a risk analysis of all recipients, taking into consideration the funding level, recent audit findings, and the last on-site monitoring visit. A rank order list was developed, resulting in a schedule for the upcoming year recipients to be visited by OVAE staff. In addition, in an effort to visit the largest possible number of recipients each year, a new system was developed within OVAE to send staff on "mini" monitoring visits as well as "full" monitoring visits. The mini-monitoring visits are less formal and enable recipient staff and the Department staff to meet and discuss current issues as well as clarify areas within the Perkins legislation. Those recipients that are deemed most at risk, however, receive the full monitoring attention.

Although OVAE has developed a method of monitoring compliance with the Carl D. Perkins Vocational and Technical Education Act of 1998 (Perkins Act), we were not provided any evidence of monitoring for our sample. With respect to the five recipients selected in our sample, monitoring was last performed as follows: three states were last monitored in 1980; one state was last monitored in 1981; and, one state was last monitored in 1994. The lack of monitoring increases the risk that grant recipients may not comply with the provisions of the Perkins Act.

We recommend that the Department implement procedures established to monitor its vocational education grants for compliance with the Perkins Act.

Department Response:

The Department concurs.

The information for FY2001 is accurate and in FY2002, the Department is implementing the procedures established for monitoring compliance with the Perkins Act.

Action to Be Taken:

- Continue conducting FY2002 full and mini monitoring site visits.
- Perform annual risk analyses to develop monitoring plans for subsequent years.

VI. Grants – Impact Aid*Grant Confirmations*

During our confirmation of available obligated balances at year-end, we noted that for two of the three local educational agencies (LEAs) in our sample, the Impact Aid Awards, payments and available obligated balances confirmed by the LEA do not agree with the balances maintained in GAPS and the Impact Aid System. For example the Impact Aid Award of \$3,780,397 reported in GAPS and confirmed by the LEA did not agree with the amount of \$3,457,053 recorded in the Impact Aid System. The payments of \$3,457,053 reported in the Impact Aid System and confirmed by the LEA did not agree with payments of \$3,067,492 recorded in GAPS.

During the conversion from the prior grant systems (the Payment Management System and the Payment Administration System to the Grant Administration and Payment System (GAPS)), certain incorrect obligation and payment balances were posted to GAPS. This caused erroneous available balances within GAPS, which directly affected the undelivered orders balances that was reported on the financial statements at year-end.

We recommend that the Department research the obligations and payments posted as a result of the conversion and reconcile GAPS to the Impact Aid System.

Department Response:

The Department concurs with the recommendation.

Impact Aid Program staff members have conducted extensive reconciliations of erroneous conversion records and forwarded the results to OCFO for correction in GAPS.

Action to Be Taken:

- One outstanding erroneous obligation and its related expenditure records remains in GAPS. The Impact Aid Program will send an explanation of the necessary corrections to OCFO.
- The Department will develop policies and procedures, which will enable the program office to reconcile the Impact Aid system to GAPS.

VII. Grant Disbursements*GAPS to FMSS Grant Expense Reconciliation*

Grantees use the Grant Administration and Payment System (GAPS) to submit drawdown requests, via the Internet, to the Department. The transactions are accumulated and electronically transmitted to FMSS, the general ledger. Consequently, the grant expense from GAPS, the subsidiary ledger, should equal the grant expense from the general ledger. During our testing, we reviewed certain reconciliations of grant expenses between GAPS and FMSS for the

period of October 1, 2000 through September 30, 2001. The reconciliations are used to show the difference between the grant expense on the financial statements and the grant expense per GAPS.

The Department has taken significant steps forward during FY 2001 to begin to routinely reconcile the GAPS to FMSS grant expenses; however, additional improvements are needed. During our testing, we noted the following issues:

1. The Department began preparing monthly reconciliations in April 2001. No monthly reconciliations were performed between October 2000 and March 2001; instead, the Department prepared a combined reconciliation for the entire six months.
2. Based on a review of the available documentation for FY 2001 reconciliations, we were unable to determine the timeliness of when the reconciliations were prepared or whether the reconciliations were reviewed and approved by a supervisor. Management has indicated that the reconciliations are approved via e-mail; however, no documentation was retained supporting the review and approval of the reconciliations.
3. We also obtained available FY 2002 documentation for the October 2001 and November 2001 GAPS-FMSS reconciliations and noted that these reconciliations were not complete as of January 2002.

Without timely reconciliations, the Department's risk of not detecting material errors or irregularities in the underlying financial data and financial statements is increased. In addition, the lack of evidence of supervisory review and approval increases the risk that reconciliations may not be finalized, potentially resulting in errors or irregularities that may not be detected timely.

We recommend that the Department perform the following:

- Refine and enhance the existing procedures for the GAPS to FMSS grant expense reconciliation.
- Develop, document, and implement additional procedures to maintain records of reconciliations when completed, as well as evidence of supervisory review and approval.
- Reinforce the need to complete monthly reconciliations on a timely basis.

Department Response:

The Department agrees that the reconciliation approval documentation can be improved, but we do not agree with the recommendations as stated.

The timeliness of reconciliations is a function of staff resource availability. There are times where consolidation of reconciliation periods is necessary to facilitate the process. All reconciliations are dated, reviewed and approved by management.

Action to Be Taken:

- Department management will maintain formal approval documentation.

VIII. Accrued Grant Liability

During our testing of the accrued grant liability estimate, we noted that some of the payees' reported liability exceeded their available balance as of September 30, 2001. Management stated that for purposes of calculating the estimated liability the reported liability is capped at the available obligated balance amount when the confirmed liability amount exceeds the available balance per GAPS. The Department did not perform any follow up discussions or procedures for grantees that reported discrepancies, such as liabilities exceeding available balances.

Without procedures to follow up on discrepancies, the risk increases that the confirmations may contain errors or irregularities and that they may not be detected timely, potentially resulting in grant liability information that is unreliable. In addition, although grantees have access to GAPS to monitor grant information, discrepancies may indicate that grantees are unaware of their available balances for grants.

The U.S. General Accounting Office's *Standards for Internal Control in the Federal Government* state that internal control activities help ensure that management's directives are carried out. The control activities should be effective and efficient in accomplishing the agency's control objectives. Examples of control activities include top level reviews of actual performance, reviews by management at the functional or activity level, segregation of duties, proper execution of transactions and events, accurate and timely recording of transactions and events, and appropriate documentation of transactions and internal control.

We recommend that the Department develop and implement written policies and procedures for following up on discrepancies noted in confirmations submitted by grantees that are used to calculate the accrued grant liability. We also recommend that the Department leverage its confirmation processes in this area to explicitly confirm grant awards, expenditures and/or advances to date, and available balances.

Department Response:

The Department concurs with the overall intent of the recommendation.

The Department understands the auditor's concerns regarding the inherent limitations and imprecision in the current, sampling-based methodology for calculating the grant accrual, and agree that we should move toward a methodology based on internal program and financial data. Using historical data accumulated over the past few years, the Department is committed to developing an internal approach.

Action to Be Taken:

- The Department will review possible approaches to a grant accrual calculation based on internal data, evaluate the pros and cons of possible techniques. The Department will develop and implement a revised methodology as appropriate.

IX. Accounts Payable

We noted that amounts recorded on the accounts payable aging schedule did not agree to accounts payable amounts recorded in the general ledger, FMSS, by approximately \$28 million. The Department was unable to provide adequate explanations as to the cause of the difference between the aging schedule and the general ledger or appropriately reconcile amounts between the two records.

OMB Circular A-123 states, "Transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports. Proper reconciliation of accounts shall consist of identification of differences between general ledger balances, subsidiary ledger, and the detail. The reconciliation must include the timely processing (preferably in the following month) of the identified items constituting the difference between controlling accounts and the detail. The documentation for transactions, management controls, and other significant events must be clear and readily available for examination."

We recommend that the Department perform the following:

- Develop controls to ensure that the data entered into the aging schedule is correct in all aspects. In addition, provide additional training to staff responsible for the data entry processing and production of the aging report.
- Refine the review and monitoring procedures over the aging report to ensure that the data produced is correct and can be used for management's intended purpose.

Department Response:

The Department concurs with the overall intent of the recommendation.

Action to Be Taken:

- The Department will evaluate the Oracle aging report as a part of the overall review of the standard accounts payable reports.
- Management will provide staff with the appropriate training and technical support.

X. Appropriations / Budget***SF-133's (Report on Budget Execution and Budgetary Resources)***

SF-133's were not submitted to OMB for the first three quarters of the fiscal year for the FFELP financing appropriation (X4251) and the direct loan financing appropriation (X4253). In addition, we noted differences between the trial balance and the 4th quarter SF-133's for appropriations X4251 and X4253. For instance, at year-end for appropriation X4253, we noted a difference of \$101 million for the Obligated Balance, Net – End of Period line item and a difference of \$1.1 million, which was related to the Spending Authority from Offsetting Collections and the Obligated Balances – Not Available line items. In addition, at year-end for